

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
CARPENTER TECHNOLOGY CORPORATION	:	AMENDED
	:	DETERMINATION
	:	DTA NO. 816680
for Redetermination of a Deficiency or for Refund of	:	
Corporation Franchise Tax under Article 9-A of the Tax	:	
Law for the Fiscal Years Ended June 30, 1990 and	:	
June 30, 1991.	:	

Petitioner, Carpenter Technology Corporation, P.O. Box 14662, Reading, Pennsylvania 19612-4662, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended June 30, 1990 and June 30, 1991.

On April 19, 1999 and April 27, 1999, respectively, petitioner, appearing by Dechert Price & Rhoads (Richard C. Kariss, Francis Mazzola, and Debra MacPhee, Esqs., of counsel) and the Division of Taxation, appearing by Terrence M. Boyle, Esq. (Kevin R. Law, Esq., of counsel) consented to have the controversy determined on submission without a hearing. All documentary evidence and briefs were due to be submitted by October 15, 1999, which date began the six-month period for issuance of this determination. After due consideration of the record, Brian L. Friedman, Administrative Law Judge, renders the following determination.

ISSUE

Whether the Division of Taxation properly disallowed certain interest expense deductions claimed by petitioner in computing its entire net income tax base and added back the interest expense as interest directly attributable to subsidiary capital pursuant to Tax Law § 208(9)(b)(6).

FINDINGS OF FACT

On June 3, 1999 and June 14, 1999, respectively, Carpenter Technology Corporation (“Carpenter”) and the Division of Taxation (“Division”) entered into a written stipulation of facts. The relevant facts are substantially incorporated into the following Findings of Fact.

1. Carpenter is a Delaware corporation that is primarily engaged in the business of manufacturing and distributing specialty steel products. Carpenter is headquartered in Reading, Pennsylvania.

2. Carpenter conducts specialty steel distribution activities in New York. It operates a warehouse in Rochester, New York which is its only New York based facility.

3. During the 1980s, Carpenter’s management decided to expand its business into foreign countries.

4. Carpenter’s management concluded that the business in each foreign country should be conducted through entities organized under the laws of the foreign countries.

5. Carpenter’s management concluded that conducting business using locally organized entities would achieve important objectives such as facilitating the importation of products manufactured by Carpenter, currency transactions, operations under local law and business relationships with local vendors and customers.

6. Carpenter’s management decided that Carpenter should not directly own the foreign entities but that those entities should be owned by domestic subsidiary corporations of Carpenter.

7. Carpenter's management decided to form viable corporate subsidiaries to own the foreign entities in order to protect Carpenter's domestic business assets from large liabilities related to business conducted in foreign countries.

8. Carpenter's management decided that to protect its domestic business assets from foreign liabilities, it would form a domestic subsidiary corporation with sufficient assets to partially insulate Carpenter from foreign liabilities by becoming an owner of certain foreign entities and thereafter form a second domestic subsidiary with sufficient assets to further insulate Carpenter from foreign liabilities by holding the remaining interest in the foreign entities, thereby divesting Carpenter of any direct ownership interest in the foreign entities.

9. Carpenter's management considered the following risks related to conducting business in foreign countries: (a) some foreign jurisdictions did not recognize the corporate limited liability concept; (b) some foreign jurisdictions did not recognize contractual limitations with respect to consequential damages; and (c) some of the products sold in the foreign countries would be used in products associated with a high product liability risk such as surgical equipment, surgical implants (e.g., hip joint prostheses, bone plates and heart catheter wire), laser systems, petrochemical storage and processing equipment, nuclear reactors, aircraft engines, landing gears of carrier-based aircraft, automobile air bags, automobile anti-lock brakes and automobile fuel injection systems.

10. Carpenter's management determined that the ownership of \$300 million of assets by the first domestic subsidiary corporation would provide the subsidiary with the substance to partially protect Carpenter's business assets from liabilities related to conducting business in foreign countries.

11. On October 12, 1989, Carpenter's Board of Directors formally considered the formation of the first domestic subsidiary corporation.

12. On October 13, 1989, Carpenter formed Carpenter Investments, Inc. ("CII") in Delaware as a wholly-owned viable subsidiary corporation, and Carpenter contributed capital in the amount of \$300 million to CII. Thereafter, CII loaned this \$300 million back to Carpenter.

13. After CII was formed, CII owned \$300 million of assets in the form of a revolving promissory note from Carpenter.

14. The note between Carpenter and CII required Carpenter to pay interest to CII at an arm's-length rate.

15. Carpenter made timely interest and principal payments with respect to the note held by CII.

16. The asset owned by CII and the fact that CII became a shareholder in several foreign corporations provided CII with economic substance and met Carpenter's business objectives of partially insulating its business assets from foreign liabilities.

17. In accordance with its business objective, Carpenter formed a second wholly-owned domestic subsidiary corporation on September 17, 1991.

18. The second subsidiary corporation became a shareholder in a foreign corporation and an owner in an interest in a foreign joint venture.

19. The second subsidiary corporation owned sufficient assets to provide that corporation with economic substance and thus Carpenter's business assets were further insulated with respect to foreign liabilities.

20. Carpenter's management concluded that it was necessary to form a third domestic subsidiary corporation to further insulate Carpenter from any foreign liabilities.

21. Carpenter formed a third wholly-owned subsidiary corporation.

22. The third subsidiary corporation owned sufficient assets to provide that corporation with economic substance and thus Carpenter's business assets were further insulated with respect to foreign liabilities.

23. To achieve Carpenter's business objective, the third subsidiary corporation became a shareholder in several foreign corporations.

24. The third subsidiary corporation's ownership interest in the foreign corporations enabled Carpenter to achieve its business objective of insulating its business assets from foreign liabilities by: (a) divesting itself of any direct ownership in the foreign businesses, and (b) establishing corporate subsidiaries with sufficient assets to insulate Carpenter's business assets from liabilities arising from the ownership of foreign businesses.

25. The domestic subsidiaries that Carpenter formed to protect its domestic business assets did not make loans to the foreign entities in which they held investment interests.

26. During the fiscal year ended June 30, 1990, Carpenter's investments in subsidiaries increased by \$299,950,881.00. On its Federal return for this period (Statement 12, pg. 50), Carpenter indicated that it had made investments in subsidiaries totaling \$300,007,232.00.

27. During the fiscal year ended June 30, 1991, CII paid a dividend to Carpenter which was, in part, based upon income earned by CII from its receipt of interest paid by Carpenter. The amount of this dividend was \$4,000,000.00.

28. During the years at issue, all of CII's income was interest income, the majority of which was the interest paid to it by Carpenter.

29. Carpenter timely filed tax returns for the tax years at issue and paid tax as reported due on those returns.

30. Carpenter filed on a consolidated basis with its affiliates for Federal income tax purposes during the tax years at issue.

31. Carpenter deducted its interest payments to CII on its pro-forma Federal forms 1120 as an expense in computing its separate company Federal taxable income during the years at issue.

32. The Internal Revenue Service examined and approved Carpenter's interest expense deductions.

33. Carpenter used Federal taxable income to compute its New York State tax base.

34. Carpenter did not add back its expense deductions as attributable to subsidiary capital in computing its tax base because, in its view, the interest expense was not incurred on behalf of Carpenter's subsidiaries.

35. On September 18, 1995, the Division issued a Notice of Deficiency to Carpenter asserting additional tax due in the amount of \$41,251.00, plus interest of \$22,083.99 and penalty of \$4,125.00, for a total amount due of \$67,459.99 for the fiscal year ended June 30, 1990 and asserting additional tax due of \$132,971.00, plus interest of \$50,768.69 and penalty in the amount of \$13,297.00, for a total amount due of \$197,036.69 for the fiscal year ended June 30, 1991.

36. Because the Division was initially unable to determine the amount of interest which Carpenter paid to CII for the period ended June 30, 1991, the Division added back all of Carpenter's interest expense. Based upon information subsequently provided by Carpenter, it was determined that the interest which Carpenter paid to CII for the period ended June 30, 1991 was \$40,167,993.00. Therefore, the amount of tax for this period should be reduced by \$56,341.00.

However, when issuing the Notice of Deficiency, the Division failed to impose the surcharge pursuant to Tax Law § 209-A. Therefore, the tax asserted to be due should be increased by \$11,495.00. Accordingly, the net adjustment to the tax for the period ended June 30, 1991 results in a reduction in the amount of \$44,846.00 (\$56,341.00 - \$11,495.00).

37. The parties agree that, except for the modification set forth in Finding of Fact “36”, the amounts asserted to be due pursuant to the Notice of Deficiency are not in dispute.

38. Along with its brief, the Division submitted three unnumbered proposed findings of fact, each of which has been substantially incorporated into the above Findings of Fact.

SUMMARY OF THE PARTIES' POSITIONS

39. Carpenter maintains:

(a) Its interest payments to CII were incurred in Carpenter's business and, therefore, its interest expense deductions related to those payments should not have been disallowed by the Division in computing Carpenter's entire net income tax base;

(b) Carpenter's interest payments to CII were not expenses attributable to subsidiary capital and, as such, should not have been disallowed by the Division in computing Carpenter's entire net income tax base. Carpenter contends that this is true because the interest expenses were not paid on behalf of CII by Carpenter and, in addition, the expenses were not incurred to enhance the investment in a subsidiary (CII), i.e., the payments were not investments in the stock of CII.

(c) Even if it were concluded that Carpenter's interest payments to CII were attributable to subsidiary capital, there was no reasonable basis for the Commissioner to invoke his discretion to disallow the deduction for the payments.

40. In response, the position of the Division is as follows:

(a) The interest paid by Carpenter to CII was interest directly attributable to subsidiary capital;

(b) Whether Carpenter initially capitalized CII with a note or with cash, the economic reality of the transaction indicates that the resulting interest expense was attributable to Carpenter's investment in CII, with the result being that there was an increase in Carpenter's investments in subsidiaries. Accordingly, the Commissioner did not abuse his discretion in requiring Carpenter to add back the interest which it paid to CII.

CONCLUSIONS OF LAW

A. There are several different tax bases which may be used to compute the franchise tax on business corporations which is imposed by Tax Law § 209. During the years at issue, Carpenter computed its tax liability using the entire net income tax base.

B. Tax Law § 208(9) provides that "entire net income" means total net income from all sources which is presumably the same as the Federal taxable income which the taxpayer is required to report to the Internal Revenue Service, modified by certain additions and subtractions set forth in the Tax Law.

One of the modifications is set forth in Tax Law § 208(9)(a)(1) which states that entire net income shall not include income, gains and losses from subsidiary capital.

C. Tax Law § 208(9)(b) provides that entire net income shall be determined without excluding, deducting or crediting:

(6) in the discretion of the tax commission, any amount of interest directly or indirectly and any other amount directly or indirectly attributable as a carrying charge or otherwise to subsidiary capital or to income, gains or losses from subsidiary capital.¹

¹ In contrast, when computing Federal taxable income, a taxpayer is allowed a deduction for interest expense on indebtedness in each report (Internal Revenue Code § 163[a]).

The purpose of denying this deduction of interest is to prevent a parent corporation from obtaining a double tax benefit by taking a deduction for interest payments on loans incurred for directly or indirectly financing investments in subsidiaries while at the same time the parent's income from such investments is tax free (*Matter of F. W. Woolworth Co. v. State Tax Commn.*, 126 AD2d 876, 510 NYS2d 926, *affd* 71 NY2d 907, 528 NYS2d 537) .

D. The term “subsidiary capital” is defined as:

investments in the stock of subsidiaries and any indebtedness from subsidiaries . . . whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under article nine-a, thirty-two or thirty-three of this chapter, provided, however, that, in the discretion of the commissioner of taxation and finance, there shall be deducted from subsidiary capital any liabilities which are directly or indirectly attributable to subsidiary capital (Tax Law § 208[4][a]).

E. In the present matter, Carpenter determined that ownership of \$300 million of assets by CII would provide the subsidiary with the economic substance to partially protect Carpenter’s business assets from liabilities related to conducting business in foreign countries. To accomplish this stated purpose, Carpenter contributed capital in the amount of \$300 million to CII and, subsequently, borrowed the money back from CII . As evidence of this transaction, CII took back a revolving promissory note from Carpenter which required Carpenter to pay interest to CII at an arm’s-length rate.²

² It is unclear from the record how the promissory note, rather than the \$300 million in capital, met Carpenter’s business objectives of partially insulating its business assets from foreign liabilities (*see*, Finding of Fact “16”). It should be noted that in its brief, Carpenter seems to contradict the stipulated finding of fact when it states that:

the transaction that gave rise to the revolving promissory note between Carpenter and CII did not enhance the equity of CII because CII merely exchanged an asset (i.e. cash) for a different asset (i.e. a note receivable) and thus, there was no effect on CII’s equity or on Carpenter’s ‘Investment in Subsidiaries’ account (Carpenter’s brief, pg. 15).

In *Matter of F. W. Woolworth Co. v. State Tax Commn.* (*supra*), that petitioner claimed a deduction of approximately \$45 million for interest payments on certain long-term and short-term debts which the Division disallowed pursuant to Tax Law § 208(9)(b)(6), as having been directly or indirectly attributable to subsidiary capital or to income, gains or losses from subsidiary capital. Despite the fact that none of the proceeds of that petitioner's borrowing went to acquire or fund additional investment in any subsidiary, the Court upheld the Division's disallowance of the interest expenses, stating:

Contrary to petitioner's contention, it is not alone sufficient to defeat disallowance of the interest deduction that the incurrence of the indebtedness can be directly attributed to a separate, bona fide business purpose. Tax Law § 208(9)(b)(6) speaks also of *indirect* attribution and, thus, envisages situations where the parent corporation may have had a dual purpose in borrowing and where the requisite connection between the debt and the investment in subsidiaries is only inferable from other facts and circumstances surrounding the pertinent transactions (*id.*, 510 NYS2d, at 928).

Specifically, the Court took notice of the fact that the petitioner had increased its investments in the subsidiaries and had, in fact, made actual cash advances to one of its subsidiaries. Taken together with other pertinent facts, the Court concluded that this petitioner had made a conscious decision to expand its investments in its subsidiaries and that the borrowing and resulting interest expenses were a necessary element in accomplishing that purpose.

On its Federal tax return filed for the year ended June 30, 1990 (CII was formed on October 30, 1989), Carpenter indicated that its investments in subsidiaries increased by \$299,950,881.00 (the return listed investments in subsidiaries at \$300,007,232.00). In the same year, Carpenter received a dividend from CII in the amount of \$4,000,000.00 which was based, in part, on income earned by CII from its receipt of interest paid by Carpenter (all of CII's

income was interest income, the majority of which was derived from the interest paid by Carpenter). While Carpenter may well have had a legitimate business purpose in forming and funding CII (whether by contributing capital or by executing the promissory note), i.e., to protect its domestic business assets from potential foreign liabilities, that fact alone cannot serve to negate the Division's determination that the interest payments were expenses attributable to subsidiary capital. As in *Woolworth (supra)*, it can reasonably be inferred from the facts and circumstances surrounding Carpenter's transactions with CII that Carpenter's interest payments were directly or indirectly attributable to subsidiary capital.

F. Carpenter points to Tax Law § 208(4)(a) which defines "subsidiary capital" as "investments in the stock of subsidiaries and any indebtedness from subsidiaries" and contends that this definition has been interpreted to mean that expenses are attributable to subsidiary capital only if the expenses are paid on behalf of the subsidiary (such as indebtedness from the subsidiary) or are incurred to enhance the investment in a subsidiary (such as investments in the stock of a subsidiary). Accordingly, Carpenter maintains, since the interest expenses paid to CII in conjunction with the promissory note were not paid on behalf of CII or were not paid to invest in the stock of CII, such expenses were not attributable to subsidiary capital and thus should not have been disallowed by the Division. In support of that contention, Carpenter cites *Matter of F. W. Woolworth Co. v. State Tax Commn. (supra)*.³

This argument by Carpenter is without merit. While it is true that, unlike the facts in *Woolworth*, Carpenter did not borrow the \$300 million from a third party, it is still paying interest on the loan and the \$300 million is reflected as an investment in subsidiaries on its books

³ Carpenter also cites to an ALJ Determination which, by virtue of 20 NYCRR 3000.15(e)(2), is not considered precedent nor given any force or effect in other proceedings in the Division of Tax Appeals.

and records. As previously noted (*see*, Conclusion of Law “E”), the Court in *Matter of F. W. Woolworth Co. v. State Tax Commn.* (*supra*) looked to the facts and circumstances surrounding the transactions in making its decision; it found such facts and circumstances persuasive and held that the debt obligations were indirectly attributable to investments in subsidiaries. As the Division correctly notes, it is important to look to the substance of a transaction rather than simply to its form, with the emphasis being on the economic reality of the transaction (*United Housing Foundation, Inc. v. Forman*, 421 US 837, 44 L Ed 2d 621; *see also, Matter of Pohatcong Industries v. Commissioner of Taxation & Fin*, 156 AD2d 791, 549 NYS2d 211; *Matter of Avon Products v. State Tax Commn.*, 90 AD2d 393, 458 NYS2d 278).

As additional support for its position, Carpenter points to a memorandum of the Division’s Technical services Bureau (TSB-M-88[5]C) which discusses expenses which are directly attributable to subsidiary, business or investment capital under Article 9-A. The following are examples, although not exclusive, of expenses attributable in whole or in part to subsidiary capital:

- (1) interest incurred to purchase subsidiary capital;
- (2) salaries of officers and employees engaged in the management, supervision or conservation of subsidiary capital;
- (3) legal expenses relating to subsidiary capital;
- (4) stewardship expenses relating to a subsidiary (see Treasury Regs § 1.861-8[e][4]; and
- (5) rent or depreciation with respect to a building, a portion of which is dedicated to the management of subsidiaries.

As previously noted, while these are examples of expenses attributable to subsidiary capital, they are certainly not the only examples. It is necessary to examine the particular facts and circumstances of the transactions at issue in order to determine whether the expenses are, in fact, attributable to subsidiary capital.

Carpenter contends that its interest payments to CII were not incurred to enhance its investment in CII and, therefore, are not expenses attributable to subsidiary capital. It states that the funds loaned to Carpenter by CII were not used to acquire or to capitalize CII or any other of Carpenter's subsidiaries and did not enhance the equity of CII because CII merely exchanged an asset (cash) for a different asset (a note receivable). An examination of the economic reality of the transaction does not support Carpenter's argument.

Carpenter's management decided to form CII (and other subsequent subsidiaries) to own the foreign entities (which would conduct Carpenter's business in foreign countries) in order to protect its domestic business assets from large liabilities related to conducting business in foreign countries. Carpenter's management then decided that the ownership of \$300 million of assets by CII would provide this subsidiary with the substance to partially protect Carpenter's business assets from these liabilities. To achieve its stated goals, Carpenter then contributed capital in the amount of \$300 million to CII. Thereafter, CII loaned this \$300 million back to Carpenter.

While Carpenter states that ownership of the \$300 million of assets in the form of a revolving promissory note from Carpenter allowed CII to achieve the desired goals of Carpenter, it is unclear how the note, rather than the initial capital contribution, helped Carpenter to attain the desired result. The only reasonable explanation for this exchange of assets was that Carpenter believed that it could obtain a double tax benefit, i.e., it could gain tax exempt income from CII pursuant to Tax Law § 208(9) which provides that entire net income does not include income or gains from subsidiary capital while, at the same time, it could gain a substantial deduction for the interest payments made to CII on the borrowing back from the subsidiary of what essentially were the funds used to capitalize this subsidiary. This is precisely what the Court, in *Matter of F. W. Woolworth Co. v. State Tax Commn.* (*supra*), was aiming to prevent.

G. Next, Carpenter contends that even if its payments to CII are attributable to subsidiary capital, the Commissioner does not have a reasonable basis to invoke his discretion to disallow the deduction for those payments. It states that it would not obtain a double tax benefit and that its income would not be distorted if the deduction for the interest payments was permitted because its payments to CII are in consideration for the use of the loan proceeds. Carpenter maintains that it did not use the loan proceeds to acquire, capitalize or pay the business expenses of a subsidiary and, as a result, it included the economic benefits from the use of the loan in its taxable income. This argument defies logic.

As previously noted herein, Carpenter has not explained how borrowing back the money which it used to capitalize its subsidiary, CII, furthers any purpose other than to gain a specific tax advantage, an advantage which both statute (Tax Law § 208[9][b]) and case law (*Matter of F. W. Woolworth Co. v. State Tax Commn., supra*) have attempted to prevent. While Carpenter has alleged that the Commissioner had no reasonable basis to invoke the discretion granted to him by Tax Law § 208(9)(b), it has advanced no rationale for this allegation. Based upon the foregoing, there is no evidence that there was an abuse of discretion due to irrationality or unreasonableness (*see, Matter of Mobil International Finance Corp. v. New York State Tax Commn.*, 117 AD2d 103, 501 NYS2d 947). Accordingly, it is hereby determined that the Division properly disallowed Carpenter's interest expense deductions and properly added back this interest expense as having been directly attributable to subsidiary capital pursuant to Tax Law § 208(9)(b)(6).

H. The petition of Carpenter Technology Corporation is denied and the Notice of Deficiency issued on September 18, 1995, as modified in Finding of Fact "36", is sustained.

DATED: Troy, New York

April 13, 2000

/s/ Brian L. Friedman
ADMINISTRATIVE LAW JUDGE